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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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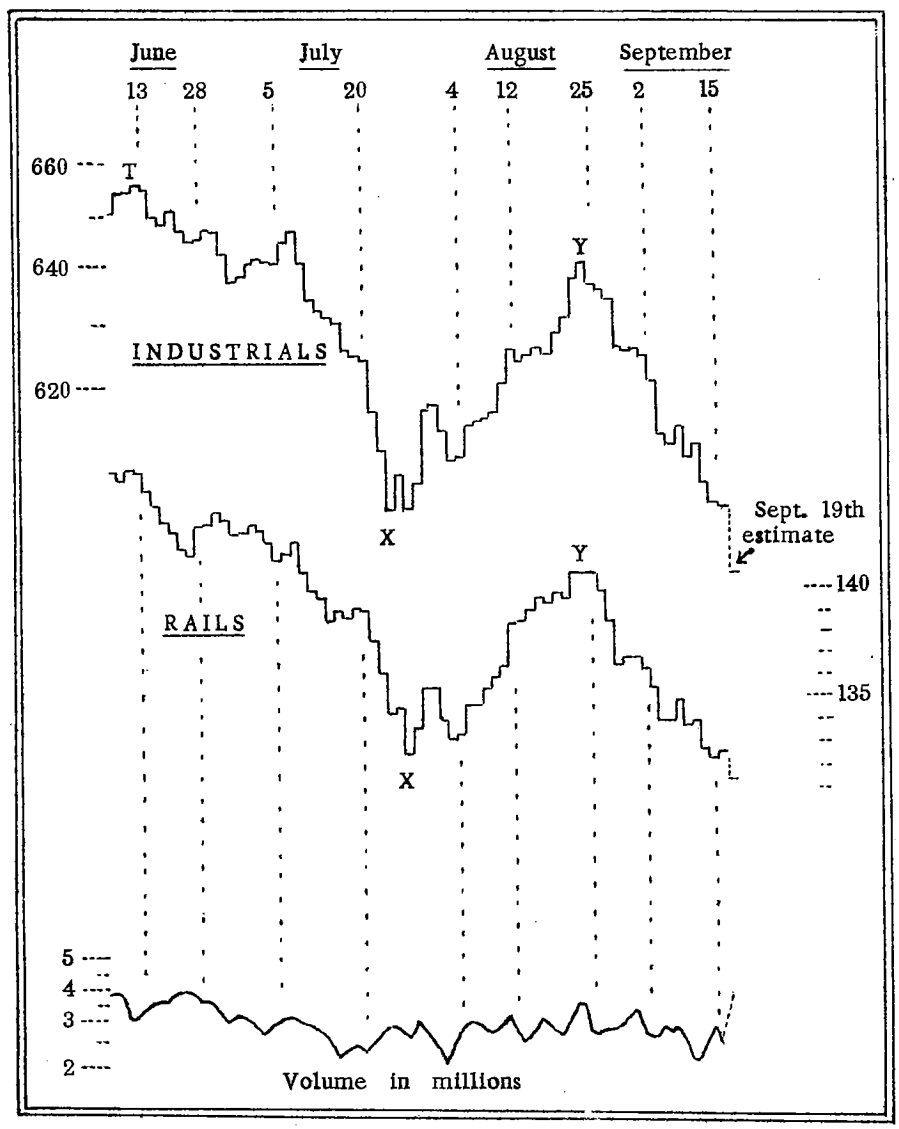
THE MARKET During a bear market the following two factors are a constant consideration: (1) Will business conditions and corporate earnings continue to deteriorate in the foreseeable future? (2) If the answer is yes, has that deterioration been fully discounted in the price structure? The first factor is fundamental, the second is technical. In a bear market the economy of the country undergoes a lengthy period of contraction. As long as investors recognize that this is the dominant force, the extended (or primary) swings of the market will be down. But since all primary movements tend to overrun themselves, the bear tide will be punctuated by short, rapid (upward) reactions. While any advance in a bear market can conceivably be the start of a new bull market, there are certain characteristics (see Letter 113) which usually identify bear market bottoms. As of this writing, neither length of time elapsed, phase, investor psychology nor current stock values suggest that a bear market bottom is at hand.

It seems to me that too much emphasis is now being placed on the short-term probable action of the market if the 599.10 Industrial low is violated, and too little emphasis on the long-term significance of such an event. For the short-term, there is not a man alive who can guess what will happen if 599.10 is broken. In my opinion, a violation would heighten the probability of a broad downward swing which could carry further than most bears expect. But on a short-term basis, there is evidence to suggest that the market is becoming oversold. If this is the case, we might see a sharp initial drop under 599.10, then a rapid, even violent rally. In general, the more panicky the break, the more acute the "pullback". At the risk of missing the move, I would not rush to put out shorts on a violation of 599.10. Shorts should have already been executed by those so inclined. I would prefer putting out shorts on any rally which started from below 599.10, particularly if such a rally (1) evidenced extreme dullness as it progressed, (2) showed signs of high volume "churning" (great activity with little upside price movement).



NOTE: As I am writing (1 P.M., Sept. 19) the market has dropped (intra-day) through the bear market lows. Volume has picked up authoritatively, and I am assuming that the 599.10 level will be decisively violated. This means that the price structure of the Averages has sustained its worst damage since March 3 when the bear signal was given. The two Averages have broken their bear market lows within three days of each other, which heightens the bearish prediction. The violation of the lows means that the third primary swing of the bear market started for Rails on March 25, 1960, at 146.56, for Industrials on June 9, 1960, at 656.42. The primary bear trend has now been reconfirmed and all three trends, primary, secondary and minor are pointing down.

TACTICS A number of investors and subscribers call here each week, and I suspect that many of them hold me somehow responsible for the bear market. I also note that a large majority of visitors still own part or all of their stocks. For some mysterious reason, however, they seem anxious to tell me why they have not liquidated. The arguments run the full financial gamut, and I have heard them many times before. "Such and such has not gone down yet"; "this stock actually rallied against the market in September"; "the taxes involved in selling Universal Snowshoe would be prohibitive"; "my mother left me this one"; "they told me Jetso was a defensive-type growth stock"; "Cyclonics is so low -- where can it go from here?"

The August issue of Barron's contains a study of mutual fund performance during the period from June 30, 1959 to June 30, 1960. The study, of course, did not include the period of the recent sharp market decline. "Of the 167 funds examined, "notes Barron's, "102 reported losses ranging from a fraction of a point to almost 20%". The funds possess professional management, and they tend to hold investment grade stocks rather than "cats-and-dogs". I am of the opinion that the average fund will outperform the average investor in a declining market. With the majority of mutual funds unable even to preserve assets over the last year, it becomes a simple question of logic whether the average investor should "ride out" a bear market or pay the cost of "insurance" (taxes and commission on the sale of his stocks).

Anyone who holds equities through a bear market is gambling on the possibility of the bear market's being a mild affair. Personally, I want no part of such a gamble. As far as my own affairs are concerned, I have been happy to pay the cost of insurance. I intend to get my nightly sleep regardless of whether the market erases another 5% or 55% from existing market values.

If a man owns a quality stock which sold for $58.00 near the top of a bull market, he will usually conjure up a figure (let us say $50.00) below which he does not believe his stock can logically drop, even in a severe market decline. But if the stock goes to $47.00, then to $43.00, the stockholder begins to lose sleep, he pesters his broker, he curses his "rotten luck". It often ends with the stockholder selling at a greater loss than he believed possible. In proof -- ask the man who owned General Motors over the last year or so.

NEWS For Dow Theorists there is both a fascination and a danger in following the day to day trends of business. The fascination lies first in observing the predictions of the Averages, then waiting for the newspapers and financial magazines to echo those predictions many weeks and even months later. The danger, of course, is that the news of the day is likely to influence or upset the thinking of the most experienced follower of Dow's Theory.

It seems almost impossible for the amateur investor to grasp the concept that the Averages fully discount events before they occur. Thus I often hear words to the effect that when this or that "inside information" is released the market will "rally 10%" or "drop 50 points". In 95% of the cases, the "secret" information has already been discounted in the movements of the Averages. This explains why the bad news which has been dotting the newspapers over the last few months has had little or no effect upon the market. The market correctly appraised the current situation six months ago (in March) when the bear signal was given. As stated in the last Letter, however, a violation of the 599.10 Industrial level would be a prediction of a new round of disagreeable financial news, news of which the public has no knowledge at this time.

It is amusing (and exasperating) to read the comments of those who insist upon arguing with the Averages. Mr. Harvey Runner of the New York Herald Tribune possesses the uncanny faculty of finding a hopeful side in any situation. Lately, however, Mr. Runner has become angry. In the Sunday Tribune of September 12, he chastises those who "appear to be bent on 'knocking down' the economy. Had an equal amount of energy and an equal amount of words been directed towards creating optimism," states Mr. Runner, "the nation today would be enjoying one of its biggest business booms ever." One is tempted to ask, "And after that what?" Mr. Runner apparently refuses to believe Hamilton's oft stated opinion that "no tree grows to the sky".

In his New York Times column entitled "The Merchant's View" (Sept. 12) Mr. William Freeman scolds the poor American consumer. (A portion of Mr. Freeman's column is reproduced on this page). Mr. Freeman may be correct in stating that the consumer's thinking is faulty and he should be buying instead of saving (or trying to pay off part of the biggest load of installment debt in history). If Mr. Freeman would take time out to study Dow's Theory, however, he might be tempted to exercise a little tolerance. He would learn that throughout history there have been periods in which savings were spent and debt was expanded; there have been other periods in which people held back on their buying while attempting to pay off the mortgage, the doctor bills and Junior's tuition. Mr. Freeman and Mr. Runner belong to the "think good thoughts and everything will come out all right" school of economics, but I suggest that Dow's Theory and a study of financial history will serve the average investor far better than all the hopes, angry words and public scoldings.

Why Does Fear Exist

Why is it that with so many people employed and earning as much as they do everyone seems to be afraid the prosperity bubble will burst? It cannot be the international situation; we have had chilling news from abroad before, and the effect has been to spur business activity. So it must be the domestic situation—the uncertainty over the election and the effect on the nation's course if Candidate A wins and the direction it will take if Candidate B is the winner.

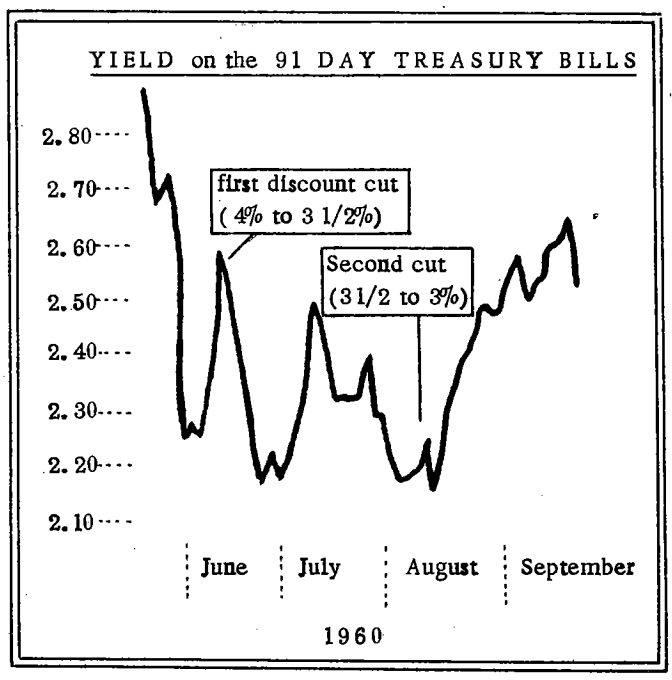
In short, the slowness of business is a direct result of some faulty thinking by consumers, who are responsible for what happens. There is no question of the basic readjustment that is going on, with inflationary pressures diminishing, but there is no reason at all for concern except, as Franklin D. Roosevelt put it, "The only thing we have to fear is fear itself."

TIDE OF MONEY In Letter 114 I wrote that I considered the Federal Reserve Board's lowering of the discount rate an attempt to manipulate the primary trend. I added that I did not think the "Fed", the President or anybody else would be successful in reversing the bearish tide. With this viewpoint in mind, it is worth examining the movements of the short-term (91 day) U. S. Treasury bills over the last few months. Even more interesting is a comparison of recent bill action with the bill action during the 1957-58 period. (For the benefit of new readers, I might add that the 91 day Treasury bills are the most sensitive of all debt instrument; they are considered to be the "pace-setters" of the money market).

During the 1957-58 market reaction and business recession, the Fed lowered the discount rate (in a series of four steps from 3 1/2% to 1 3/4%. As a result, the yield on the 91 day bills plunged from 3.65% to 0.65%. In other words, the money market responded to the Fed's "easy money" policy quickly and violently.

The accompanying chart shows the movements of yields on the 91 day bills from mid-1960 to the present. In June, 1960, the Fed lowered the discount rate a full 1/2% from 4% to 3 1/2%. Treasury bill yields dropped to a low of 2.13%, held, then backed and filled. On August 12 a second reduction brought the discount rate down to 3%. But this time the money market stubbornly refused to respond. A double bottom (see chart) formed in treasury bill yields, and following the second discount rate cut, bill yields started to advance. By last week three preceding yield peaks had been hurdled and bills were selling at their highest yields (and lowest prices) since June, 1960. There are many arguments as to why bills are weakening in price, but one thing is certain -- the money market has proved to be immune to the Fed's manipulations.

Perhaps the explanation for today's "strange" happenings was provided by Dow many years ago. In an editorial (October 2, 1902) he wrote, "Dear money, after a period of prosperity, does not always mean an immediate turn in the tide. It is sometimes a feature of current business a year before the turn comes, but, after dear money has once come, it usually recurs until it has its effect. The effect is always the same in the end. It means contraction, curtailment and lessened demand for funds".



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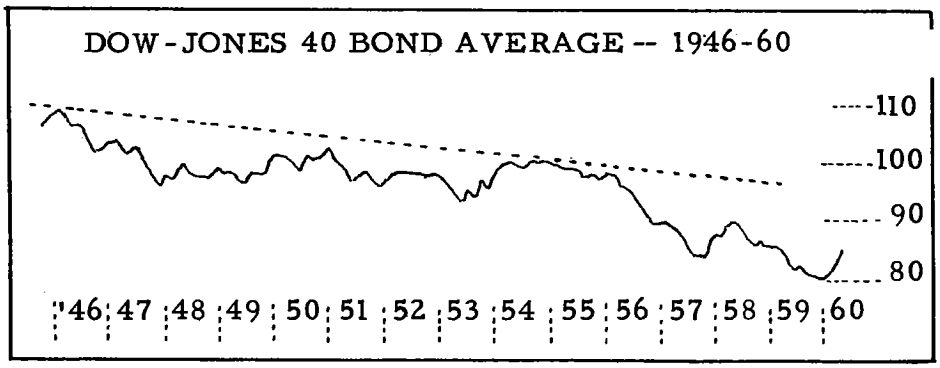
I have frequently stated (contrary to prevailing opinion) that I believed the bond market to be in a continuing long term bear market (see Letter 101). The accompanying chart shows the movements of the D-J 40 Bond Average from 1946 (the peak of the 1921-46 bull market in bonds) to the present. Note the sharp "reaction" type advance in the 40 Bond Average during 1960. The move (so far) closely resembles the 1953 and 1957 advances. Because of the foregoing, I continue to suggest that subscribers place available cash in short-term treasuries (182 day bills or less) and refrain from buying long-maturity bonds. There is no questioning the fact that U. S. Treasury bills are the safest and most liquid form of security available.

(The First Boston Corp., 15 Broad St., N. Y. C.) puts out an excellent

142 page booklet called "Securities of the U.S. Government". There is no charge for this publication).

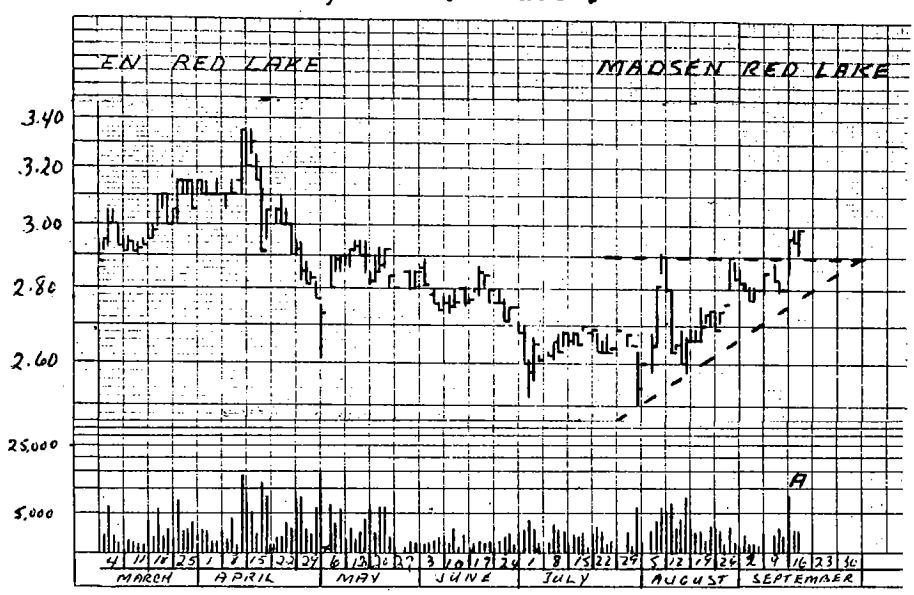


QUESTION "In your market interpretations you have laid a good deal of stress on third phase characteristics of bull markets. Is this third phase your own idea or was it described by previous Dow Theorists?"

ANSWER The third phase was not my idea. Hamilton mentioned the third phase many times in his editorials. In a piece written for Barron's (June 25, 1923) entitled "Three Stages of a Bull Market" Hamilton wrote: "The third stage of a bull market is equally clear and is still to be anticipated in the present market, unless all records fail. This is the stage where general confidence is discounting not merely present values but future possibilities." A third phase warning was provided by Hamilton in his April 25, 1929, editorial in the Wall Street Journal: "The student should ask himself if stocks are not selling well above the line of values, if people are not buying upon hope which may at least be deferred long enough to make both the heart and the pocketbook sick."

Rhea also made numerous references to the three phases. In late 1936 he wrote: "This is the phase where worthless stocks are bought for no other reason than because they look cheap, and because gamblers hope they will double in price. This condition always has prevailed in the third phase of bull markets..."

FOLLOW-UP ON GOLD My friend Iain Fraser of Stock Market Trends (199 Bay St. Toronto) says in his recent report, "As we look over our more than 150 charts, the group that stands out as clearly being the strongest is the gold stock group; we also want to point out that the price of gold on the London Market has been moving up recently..." A number of low-priced (speculative) gold stocks are in interesting and bullish chart formations (most are in ascending triangles, which suggests accumulation). Following are a few of these Canadian golds, New Dickenson, Madsen Red Lake, Consolidated Mosher, Bernat. Dome mines touched a new high last week and was previously recommended. Chart below courtesy of Mr. Fraser.



(Written September 19th, Monday, 1 P.M.)